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TAGS: ECON EFIN PO
SUBJECT: PORTUGAL'S ECONOMIC RECOVERY MODEST BUT CONVINCING

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Summary and Overview:

¶1. Proving the skeptics wrong, Portugal's Socialist government managed to reduce the budget deficit to 4.6% in 2006 from an all time high of 6.0% in 2005 and increase GDP growth to 1.4% from 0.3%. Even the ever cautious Bank Governor noted that Portugal's economic recovery, though modest, was convincing. Parliament recently passed Portugal's 2007 budget with its focus on science and technology (S&T), education and personnel resources, equitable social security distributions, and the EU Presidency. Whereas the 2006 budget strategy increased revenue via taxes, the 2007 budget aims to reduce the deficit to 3.7% via reduction of public expenditures and structural reforms. Socialists and opposition alike agree that the government must implement the more challenging reforms during the first half of 2007 as the entire administration's focus will have turned to Portugal,s EU Presidency in the latter half.

Proving the Skeptics Wrong:

¶2. Prime Minister Socrates was able to prove the skeptics wrong by reducing the budget deficit to 4.6% in 2006 from an all time high of 6.0% in 2005 and increase GDP growth to 1.4% from 0.3% during the same timeframe. Even the ever cautious Bank of Portugal Governor Vitor Constancio noted that Portugal's economic recovery, though modest, was convincing, adding that budget constraints had actually held GDP growth back by 0.6%. Naturally, Portugal's recovery was linked to the EU's recovery. However, Constancio asserted that 90% of Portugal,s growth was due to a 9% increase in exports - fueled surprisingly by an increase in oil exports. In 2006, Portugal had an excess of gasoline due to the increasing domestic purchase of diesel cars.) Although Portugal hopes to increase the use of its underutilized refinery, Constancio believes future growth should be supported by increased domestic demand rather than exports.

2007 Key Economic Indicators

	2006	2007	2008	2009
Budget Deficit	-4.6	-3.7	-2.7	-1.5
GDP Growth	1.4	1.8		
Inflation	2.5	2.1		
Unemployment	7.6	7.5		
Export Growth	8.6	7.2		
Import Growth	2.8	3.7		

Source: Government of Portugal 2007 Budget Proposal

Defending the 2007 Budget:

¶3. In defense of the government's 2007 budget, PM Jose Socrates proclaimed that his administration had accomplished everything it set out to do in 2006 despite the nay-sayers. He commented that "Not only are we eliminating the deficit, but we are also implementing structural reforms that will guarantee that the country will never suffer another budget crisis.... We have gone from a country with a total absence of reform to being one of the most reform minded countries in Europe." On November 30, 2006, Parliament,s Socialist majority passed the 2007 budget, approving only nine of the 800 proposed alterations. As expected, the opposition voted against the budget although some Social Democrats have admitted that the Socialists are taking economic measures which they should have taken while in power.

2007 Budget Overview
(in billions of euros/Percentage of GDP)

	2005	2006	2007
Total Expend- iture	70.417 (47.8%)	70.669 (46.3%)	72,538 (45.4%)
Total Receipts	61.523 (45%)	63.541 (41.7%)	66.628 (41.7%)
Balance	-6	-4.6	-3.7
Publ Debt	94,394 (64%)	102,948 (67.4%)	108,598 (68%)

Source: 2007 Government of Portugal Budget Proposal

Reallocating Resources:

¶4. Ranked by foreign investors as one of the least competitive countries in Europe, Portugal is hoping to increase productivity by strengthening S&T (the budget allocates a 64% increase in R&D funds), enhancing primary and secondary education, and bolstering worker qualifications.

The Minister of Primary and Secondary Education faces the particularly difficult task of bettering education with an ever-declining budget. Though consistently ranked as one of the most unpopular ministers in public surveys, everyone with whom DepCouns spoke had high praise for the Minister,s reforms, including her willingness to close schools with less than ten students and require teachers to double their hours from 15 to 30 hours a week.

Preparing for the EU Presidency:

¶5. Portugal places great importance on its upcoming role as EU President during the latter half of 2007. During this time, Portugal will focus on the challenges of enlargement, job growth and competitiveness, liberty, security, justice and immigration, and enhancing the EU's ability to respond to external challenges (e.g. UN peacekeeping, Africa, Russia, China and India). Despite this ambitious agenda, budget constraints have forced the government to allocate only 45 million euros to the Ministry of Foreign Affairs (MFA) for EU Presidency-related activities. Although total government expenditure for the EU Presidency will be slightly greater than 51 million euros after incorporating all ministeral contributions, the MFA is relying heavily on corporate sponsorships to make up any shortfall. As a reference, the Finnish Presidency allocated 70 million euros for its recent Presidency and the Germans have allocated 140 million euros for the current term.

Ministry Budget Allocation for EU Presidency
(in thousands of euros)

Foreign Affairs	45,000
General State Charges	730
Interior	50
Finance & Public Adm.	100

Defense	2,000
Justice	1,820
Environment	57
Agriculture	1,206
Public Works	6
Education	250
Culture	323
Total:	51,542

Source: Government of Portugal 2007 Budget Proposal

Reducing the Budget through Structural Reforms ...

¶6. The government has promised not to raise taxes as it did in 2006 but instead aims to reduce the deficit to 3.7% in 2007 via structural reforms and reduction of public expenditures. All agree that the government must tackle the most difficult challenges during the first half of 2007 before the leadership is consumed by the EU Presidency. If not implemented by then, the government will not have the results necessary for a final push on its economic reform agenda and will not be able to trumpet them in the run-up to the 2009 national elections.

... in Public Administration:

¶7. One of the more pressing problems is a bloated civil service. The government plans to eliminate 75,000 civil service positions by 2009 through attrition, retirement and mobility - a savings equivalent to 2% of GDP. In 2006, it eliminated 5,900 positions. In 2007, the government plans to introduce a new civil service system, revise compensation, introduce merit-based promotion, and eliminate a minimum of 12,000 positions - a savings of 13.42 billion euros in personnel expenditures.

... in Social Justice, Social Security and Banking

¶8. The government is also determined to reduce non-socially justifiable subsidies to wealthy and more equitably distribute welfare and social security benefits to the elderly and the poor. In 2006, it increased worker and employer contributions to the social security system. For 2007, the government announced that it was closing banking loopholes and raising the sector's - one of the country,s most profitable - required contribution to the social security system by 180-230 million euros. Such actions have resulted in the nation's bankers and trade unionists calling Finance Minister Teixeira dos Santos arrogant. Despite these accusations, Finance Minister Teixeira dos Santos decided to proceed with the proposed reforms after having determined the

time for talk was over, according to Ministry sources.

Ministry Expenditures:

¶9. The government has also cut total Ministry expenditures by 5% - about 2.390 billion euros or 1.56% of GDP. The public will be most directly affected by budget changes in the areas of education, health and Social Security.

Expenditure on Ministries
(in billions of euros)

	Expend-itures	% Change in Consolidated Budget from 2006	% of Central Admin Expenses	% of GDP
Gen State	3.511	4.1	6.4	2.2
Interior	1.682	4.6	3.1	1.1
MFA (a)	.373	6.3	0.7	0.2
Finance and Public Adm (b)	17.212	3.2	31.5	0.3

Defense (c)	2.046	2.5	3.7	1.3
Justice (d)	1.290	10.9	2.4	0.8
Environment	.560	-8.4	1.0	0.4
Economy (e)	.705	-46.2	1.3	0.4
Agriculture and Fishing	2.058	5.7	3.8	1.3
Public Works, Transportation and Communications	.954	-10.5	1.7	0.6
Work and Social Solidarity	7.184	5.9	13.2	4.5
Health	8.577	-0.4	15.7	5.4
Education	5.842	-4.2	10.7	3.7
Science & Tech and Higher Ed	2.353	7.9	4.3	1.5
Culture	.236	-7.0	0.4	1.0

Source: Government of Portugal 2007 Budget

a - The Ministry of Foreign Affairs would actually suffer a 5% decrease if not for the additional EU Presidency funds.
b - Much of this expenditure is due to previously accrued debt.
c - Much of this expenditure is due to prior equipment purchases.
d - Increase in expenditure due to new accounting measures.
e - Huge decrease in expenditure due to elimination of fees and services related to de-bureaucratization program.

¶10. Problems Remain:

Despite having rounded the corner, Portugal still faces a number of hurdles. Eurostat figures reflect a drop of Portugal's per capita GDP from 80% of the EU-25 average in 2001 to 71% in 2006, causing the country to drop three notches to 18th place in purchasing power parity, behind Greece, the Czech Republic and Slovenia. Such statistics raise doubts as to whether Portugal's GDP growth will ever converge with the EU's average. High taxes remain problematic. While the government has stated that it will not reduce taxes until 2009 to allow for reforms to take effect, some Social Democratic opponents have accused the government of delaying the decrease as an election ploy and want to see a tax reduction now to stimulate the economy.

¶11. Comment: Press reports indicate that despite a rocky start in July 2005, Finance Minister Fernando Teixeira dos Santos has won the respect of European Commissioner for the Economy and Monetary Affairs Joaquin Almunia for his hard work and determination to reduce Portugal's budget deficit below 3% by 2008. While acknowledging the country's strong progress on reforms, Almunia has warned that Portugal will be subject in 2007 to zero tolerance - i.e. no further reform delays. Teixeira dos Santos also enjoys the continued support of the Portuguese public - a reflection of the public's broad support for Socrates,s economic agenda. The Portuguese understand that there is no quick fix for their current dilemma. In fact, Portugal has been held up by the EU as an example of what not to do when joining the Eurozone. However, most Portuguese appear determined to stick by the reforms until they bear fruit rather than ceding further ground to new EU member states.
O'Neal